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NO._____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

CWT FARMS, INC. and CWT INTERNATIONAL, INC.,

Petitioners

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent

On Petition For Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Were commissions receivable paid by Petitioner CWT Farms, Inc. to Petitioner CWT International, Inc. more than sixty days after the end of the taxable year of CWT International, Inc., qualified export assets under I.R.C. § 993(b)(3) (1982) notwithstanding that Treas. Regs. § 1.993-2(d)(2) and § 1.994-1(e)(3) require that such commissions be paid within sixty days?

2. Did demand notes from Petitioner CWT Farms, Inc. to Petitioner CWT International, Inc. satisfy the requirement of I.R.C. § 993(d)(1)(B)(1982) that a "Producer's Loan" have a stated maturity date not more than five years from the date of the loan?

LIST OF AFFILIATED COMPANIES

Twin Oaks Hatchery, Inc., a Georgia corporation, majority shareholder of CWT Farms, Inc.

CWT Farms, Inc., a Georgia corporation, sole shareholder of CWT International, Inc.

CWT International, Inc., a Georgia corporation.

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The opinion of the United States Court of Appeals for the Eleventh Circuit is reported at 755 F.2d 790, 55 AFTR 2d 85-1207, 85-1 USTC ¶ 9277 (11th Cir. 1985).

JURISDICTION OF COURT

The decision of the Eleventh Circuit Court of Appeals was entered on March 19, 1985, and mandate issued on April 11, 1985. Jurisdiction to review the decision of the Court of Appeals by writ of certiorari is pursuant to 28 U.S.C. § 1254(1) (1982).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are reproduced in the Appendix in the following order:

I.R.C. § 992(a) (1982)
I.R.C. § 993(a) (1982)
I.R.C. § 993(b) (1982)
I.R.C. § 993(d) (1982)
I.R.C. § 994 (1982)
I.R.C. § 995(a) (1982)
I.R.C. § 995(b)(1) (1982)
I.R.C. § 996(a)(1) (1982)
I.R.C. § 7805(a) (1982)
I.R.C. § 7805(b) (1982)
Treas. Reg. § 1.993-2(d), T.D. 7514,
1977-2 C.B. 266, 275
Treas. Reg. § 1.994-1(e)(3)-(5), T.D. 7364,
1975-2 C.B. 315, 321,
as amended by T.D. 7435,
1976-2 C.B. 238, 239-40.

STATEMENT OF THE CASE

The case was originally filed in the United States Tax Court to redetermine corporate tax deficiencies under I.R.C. § 6213 (1982). After Petitioners lost in the Tax Court, they appealed to the United States Court of Appeals for the Eleventh Circuit under I.R.C. § 7482 (1982). On March 19, 1985, the Court of Appeals affirmed the decisions of the Tax Court.

Petitioner CWT Farms, Inc. ("Farms") is a Georgia corporation with its principal place of business in Gainesville, Georgia. Farms produces poultry products for sale in domestic and export markets. Petitioner CWT International ("International"), a wholly-owned subsidiary of Farms, is a commission agent for Farms' export sales under a written sales franchise agreement. International made an election to be a Domestic International Sales Corporation ("DISC") under I.R.C. § 992(a)(1)(D) (1982). The issues in this case concern International's status as a DISC during its taxable years ending September 30, 1975, September 30, 1976, and September 30, 1977.

During each taxable year, International earned commissions on Farms' export sales made during the year. The amounts of these commissions were determined under the special intercompany pricing rules of I.R.C. § 994 (1982) and under the terms of the sales franchise agreement. These commissions were accrued as commissions payables and commissions receivables on the books of Farms and International at year-end; the commissions were not actually paid until more than sixty days after the end of the taxable year. The commissions were paid as follows:

Taxable Year Ending	**Date Paid**
September 30, 1975	December 15, 1975
September 30, 1976	December 8, 1976
September 30, 1977	December 20, 1977

Also during each taxable year at issue, International loaned money to Farms. Farms and International described these loans on their books as "Producer's Loans." The loans were evidenced by dated notes which were payable to the order of International "on demand." Farms paid each loan by renewal within five years after the date of the original loan.

In his Notice of Deficiency dated May 28, 1980, the Com-

missioner of Internal Revenue (the "Commissioner") determined that International was not a DISC during its taxable years ending September 30, 1975, September 30, 1976, and September 30, 1977. The Notice stated that International failed to meet the requirement of I.R.C. § 992(a)(1)(B) (1982) that the adjusted bases of qualified export assets equal or exceed ninety-five percent (95%) of the adjusted bases of all of the DISC's assets at the close of its taxable year.

Specifically, the Commissioner determined that two types of assets held by International at year-end were not qualified export assets. The first, commissions receivables from Farms, failed to qualify solely because the commissions were not paid within sixty days after the end of International's taxable year, as required under Treas. Regs. § 1.993-2(d)(2) and § 1.994-1(e)(3). The Commissioner also determined that the producer's loans from International to Farms were not qualified export assets because they failed several requirements under I.R.C. § 993(d) (1982), including the requirement that a producer's loan be evidenced by an obligation having a "stated maturity date not more than 5 years from the date of the loan."

The Tax Court ruled that International was not a DISC for any of the taxable years at issue because the producer's loans were not qualified export assets. Specifically, the Tax Court held that the demand notes failed the statutory requirement of a stated maturity of five years or less. *CWT Farms,* 79 T.C. 86, ¶ 79.5 P-H T.C. (1982).

On Petitioners' Motion for Reconsideration, the Tax Court issued a Supplemental Opinion which held that the commissions receivables were not qualified export assets. The Tax Court rejected Petitioners' challenges to the validity and the retroactive application of Treas. Regs. § 1.993-2(d)(2) and § 1.994-1(e)(3) (the 60-day payment rule). *CWT Farms,* 79 T.C. 1054, ¶ 79.68 P-H T.C. (1982).

On March 19, 1985, the Eleventh Circuit affirmed both opinions of the Tax Court. *CWT Farms, Inc. v. Commissioner,* 755 F.2d 790, 55 AFTR 2d 85-1207 (11th Cir. 1985). The court rejected the Second Circuit Court of Appeals' holding in *Lecroy Research Systems Corp. v. Commissioner,* 751 F.2d 123, 55 AFTR 2d 85-475 (2d Cir. 1984), *rev'g* ¶ 84,145 P-H Memo T.C. (1984), that the sixty-day payment regulations could not be applied retroactively. The Eleventh Circuit also rejected the Claims Court's conclusion that Treas. Reg. §

1.993-2(d)(2) is invalid, as held in *Thomas International Limited v. United States,* 6 Cl. Ct. 414, 54 AFTR 2d 84-6071 (1984), *appeal docketed,* No. 85-870 (Fed. Cir. Dec. 11, 1984).

REASONS FOR GRANTING THE WRIT

Introduction

The petition for certiorari should be granted because: (1) there is a direct conflict between the Second Circuit Court of Appeals and the Eleventh Circuit Court of Appeals; (2) there is a potential conflict between the Federal Circuit Court of Appeals and the Eleventh Circuit Court of Appeals which may become a direct conflict prior to the time the Court rules on the petition; (3) the Eleventh Circuit's decision conflicts with applicable decisions of this Court; and (4) the issues involved are important questions of federal law not previously decided by the Court.

I. The Eleventh Circuit's Decision Directly Conflicts With The Second Circuit's Holding In *Lecroy Research Systems Corp. v. Commissioner,* 751 F.2d 123 (2d Cir. 1984), That Treas. Regs. § 1.993-2(d)(2) and § 1.994-1(e)(3) May Not Be Applied Retroactively.

In *Lecroy Research Systems Corp. v. Commissioner,* 751 F.2d 123, 55 AFTR 2d 85-475 (2d Cir. 1984), the Circuit Court held that because of promises made in a Treasury publication entitled *DISC — A Handbook For Exporters* (the *"Handbook"*) (reproduced in pertinent part at 1972-1 C.B. 679), Treas. Regs. § 1.993-2(d) and § 1.994-1(e)(3) could not be applied retroactively. The court first acknowledged the established rules that tax regulations are applied retroactively and that taxpayers may not prevent retroactive application by showing reliance on informal Treasury publications. *See* I.R.C. § 7805(a) (1982); *Dixon v. United States,* 381 U.S. 68, 85 S. Ct. 1301, 14 L. Ed. 2d 223 (1965); *Adler v. Commissioner,* 330 F.2d 91, 93 (9th Cir. 1964); *Carpenter v. United States,* 495 F.2d 175, 184 (5th Cir. 1974). The Second Circuit noted, however, that the Commissioner's failure to limit retroactive application of regulations is reviewable for abuse of discretion. *See Dixon v. United States,* 381 U.S. 68, 71-75,

85 S. Ct. 1301, 1303-05, 14 L. Ed 2d 223 (1965). Additionally, the court stated that "there are judically enforceable limits on the Commissioner's discretion to ignore prior assurances given to taxpayers," citing *Lansons, Inc. v. Commissioner,* 622 F.2d 774, 778 (5th Cir. 1980); *Anderson, Clayton & Co. v. United States,* 562 F.2d 972, 981 (5th Cir. 1977), *cert. denied,* 436 U.S. 944 (1978); *Elkins v. Commissioner,* 81 T.C. 669, 677 (1983). Applying these principles to the case, the Second Circuit held that the retroactive application of the challenged regulations was an abuse of the Commissioner's discretion under I.R.C. § 7805(b) (1982).

The *Handbook* contained three sections, the first two of which were intended as plain-language overviews of DISCs, while the third section set forth technical guidance to DISCs. The *Handbook* did not expressly state whether commissions receivables by an agent DISC from its principal were qualified export assets, though it did state that accounts receivable of the principal purchased by a commission agent DISC were qualified export assets. Regulations treating commissions receivables as qualified export assets under I.R.C. § 993(b)(3) (1982), and requiring payment of commissions within sixty days after the taxable year of the DISC were first proposed in 1972. *See* 37 Fed. Reg. 19625, 19627-19628 (September 21, 1972) and 37 Fed. Reg. 20853, 20858 (October 4, 1972). The sixty-day payment rule remained unchanged through several revisions to the proposed regulations and became final regulations on September 29, 1976. T.D. 7435, 1976-2 C.B. 238.

The *Handbook* stated that the rules and procedures contained in the third section would be followed by Treasury *"[u]ntil such time as they may be modified in regulations or other Treasury publications. Any such modifications which may be adverse to taxpayers will apply prospectively only."* 1972-1 C.B. 679, 682 (Emphasis supplied). The Second Circuit observed that "the *Handbook's* assurances were deliberately unusual in purporting to offer safety in the *status quo* and were obviously prompted by the need to render the incentives Congress intended to create operable as soon as possible." *Lecroy,* 751 F.2d at 126-27, 55 AFTR 2d at 85-478. The court emphasized that the DISC legislation was not designed to raise revenue but to increase exports and reduce the unfavorable balance of payments. The *Handbook,* with its promise of prospectivity, encouraged businesses to act quickly without

waiting for settled guidance. The Second Circuit felt that if the *Handbook's* promise of prospectivity is ignored, the result is "harsh and unfair," and that the retroactive application of the regulations "smells of a bushwhack." *Lecroy,* 751 F.2d at 127-28, 55 AFTR 2d at 85-479.

The Eleventh Circuit held that the Commissioner did not abuse his discretion in failing to limit the retroactive effect of the challenged regulations. The court stated that "[t]axpayers who rely on Treasury publications, which are mere guidelines, do so at their peril." *CWT Farms,* 755 F.2d at 804, 55 AFTR 2d at 85-1218. The Eleventh Circuit also emphasized that the proposed regulations containing the sixty-day payment rule were available early to taxpayers (1972) and noted that the proposed regulations were "other Treasury publications" as described in the promise in the *Handbook. CWT Farms,* 755 F.2d at 804 and n. 15, 55 AFTR 2d at 85-1218. On this last point, the Second Circuit reasoned that the operative words in the Handbook's promise were not "other Treasury publications," but "until... modified." Proposed regulations are not modifications of policy and procedure; they are merely suggestions for comment. *Lecroy,* 751 F.2d at 127, 55 AFTR 2d at 85-478.

In conclusion, there is a direct conflict between the circuits concerning the retroactive effect of the sixty-day payment rule and the Commissioner's exercise of his discretion under I.R.C. § 7805(b) (1982). The Second Circuit has taken a novel but correct stance on the binding effect of a unique Treasury publication, while the Eleventh Circuit has largely ignored the special circumstances which justify a departure from the general rule that taxpayers may not rely on informal Treasury publications. The resolution of the retroactivity issue in favor of Petitioners affects their taxable year ending September 30, 1975, because the regulations did not become final until September 29, 1976.

II. The Eleventh Circuit's Decision Directly Conflicts With The Claims Court's Holding In *Thomas International Limited v. United States,* 6 Cl. Ct. 414 (1984) (On Appeal To The Federal Circuit) That Treas. Reg. § 1.993-2(d)(2) Is Invalid, And Thus There Is A Potential Conflict Developing Between The Eleventh Circuit And The Federal Circuit.

The Claims Court has ruled that Treas. Reg. § 1.993-2(d)(2)

is invalid in *Thomas International Limited v. United States,* 6 Cl. Ct. 414, 54 AFTR 2d 84-6071 (1984) *appeal docketed,* No. 85-870 (Fed. Cir. Dec. 11, 1984). If the Federal Circuit affirms the Claims Court, then there will be a direct conflict between the Federal Circuit and the Eleventh Circuit. Petitioners understand that at the date of filing of this petition the appeal in the Federal Circuit has been briefed and argued (arguments heard in May 1985). There is also another case from the Tax Court which the taxpayer appealed concerning the validity of Treas. Reg. § 1.993-2(d)(2). *See Gehl Company v. Commissioner,* P-H T.C. Memo 1984-667 (1984), *appeal docketed,* No. 85-1326 (7th Cir. Feb. 26, 1985). Petitioners understand that the taxpayer's opening brief has been filed in the *Gehl Company* appeal. The issue of the validity of the sixty-day payment regulations was also considered and upheld in *Lecroy Research Systems Corp. v. Commissioner,* 751 F.2d 123, 55 AFTR 2d 85-475 (2d Cir. 1984), *rev'g on other grounds* ¶ 84,145 P-H Memo T.C. (1984). Petitioners urge this Court to construe the holding in *Lecroy* as dicta because it was not necessary to the decision of the appeal, as recognized by the Second Circuit. *Lecroy,* 751 F.2d at 125, n. 1, 55 AFTR 2d at 85-477, n. 1. In any event, the Second Circuit gave the issue a cursory analysis and did not appear to consider all aspects of the issue considered by the Claims Court and the Eleventh Circuit.

The Claims Court held that the challenged regulation was invalid because in drawing a distinction between commissions receivables from a DISC's related supplier and accounts receivables from unrelated persons, the Commissioner added a condition or exception to the statutory language. *Thomas International,* 6 Cl. Ct. at 419-20, 54 AFTR 2d at 84-6074, 84-6075. The relevant statutory language is I.R.C. § 993(b)(3) (1982) which provides in pertinent part:

> (b) Qualified Export Assets — For purposes of this part, the qualified export assets of a corporation are —
>
> * * * * *
>
> (3) accounts receivable and evidences of indebtedness which arise by reason of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraphs (A), (B), (C), (D), (G) or (H), of subsection (a)(1);

The Claims Court rejected the Tax Court's conclusion in *CWT Farms, Inc. v. Commissioner,* 79 T.C. 1054, ¶ 79.68 P-H T.C. (1982), that I.R.C. § 993(b)(3) (1982) is ambiguous, and found that in light of the entire statute the alleged ambiguity is "more apparent than real." *Thomas International,* 6 Cl. Ct. at 419, 54 AFTR 2d at 84-6074. The Claims Court held that the statute is not ambiguous because I.R.C. § 993(f) (1982), which defines "gross receipts" in the case of a commission DISC, and I.R.C. § 994(b) (1982), which authorizes regulations for pricing rules "in the case of commissions," show that Congress intended that commission DISCs be treated on equal footing with DISCs that buy goods from related suppliers for resale to third parties ("buy-sell DISCs"). If a commission DISC, which would not ordinarily have substantial tangible assets, were required by the statute to exclude its commissions receivables from qualified export assets while including them in its total assets, it could never meet the 95 percent qualified export assets test of I.R.C. § 992(a)(1)(B) (1982) and could not be a DISC. Thus, the term "accounts receivable," as used in I.R.C. § 993(b)(3) (1982), "must necessarily be understood to include sales in which the DISC is assigned by the producer the role of commission agent rather than reseller." *Thomas International,* 6 Cl. Ct. at 419, 54 AFTR 2d 84-6074.

The Eleventh Circuit followed the Tax Court's conclusion in *CWT Farms* that the term "accounts receivable" in I.R.C. § 993(b)(3) (1982) did not expressly include "commissions receivable" and the Tax Court's conclusion that this made the statute ambiguous. Thus, reasoned the Eleventh Circuit, the Tax Court correctly sought to determine whether the regulation is consistent with the statute's origin and purpose, under the rationale of *United States v. Vogel Fertilizer Co.,* 455 U.S. 16, 102 S. Ct. 821, 70 L. Ed. 2d 792 (1982). *CWT Farms,* 755 F.2d at 799, 55 AFTR 2d at 85-1214. The Claims Court apparently would not disagree that, if the statute is ambiguous, then an interpretative regulation might clarify the ambiguity, so long as it does so in a manner consistent with the statute's origin and purpose. But the court notes that significant authority holds that Treasury may not by an interpretative regulation add an exception to or supply an omission in a statute which Treasury believes Congress should have included, but did not. *Thomas International,* 6 Cl. Ct. at 420, 54 AFTR 2d at 84-6075. *See Commissioner v. Acker,* 361 U.S. 87, 80 S. Ct. 144, 4 L. Ed. 2d 127 (1959); *Helvering v. Credit Alliance*

Corp., 316 U.S. 107, 62 S. Ct. 989, 86 L. Ed. 1307 (1942).

The Claims Court held that the Tax Court's justification for the sixty-day payment rule in *CWT Farms* is not sustainable as an interpretation of any statutory language. The court characterized the regulation as "an effort to close a loophole by adding a requirement to the statute which Congress failed to adopt." *Thomas International,* 6 Cl. Ct. at 420, 54 AFTR 2d at 84-6075. The Claims Court also ruled that the challenged regulation added an *arbitrary* requirement which created a conclusive presumption against the taxpayer, regardless of bona fide reasons for failure to pay commissions within sixty days. The regulation denies the taxpayer an opportunity to show that the funds which could have been used to pay commissions were used for legitimate export-related purposes. *Thomas International,* 6 Cl. Ct. at 420, 54 AFTR 2d at 84-6075.

The Eleventh Circuit, however, held that the challenged regulations were not arbitrary and were harmonious with the purposes of the statute. One important purpose of the DISC statute, the court noted, was to insure that the tax benefits derived from a DISC be used for export production and not for domestic purposes. By requiring prompt payment of the commissions to a DISC, the regulations help to prevent interest-free loans between a DISC and a related person which could be used for domestic purposes, reasoned the Eleventh Circuit. *CWT Farms,* 755 F.2d at 801-02, 55 AFTR 2d at 85-1216.

Petitioners believe that the Eleventh Circuit failed to focus on the effect of the sixty-day payment rule. If commissions are not paid in accordance with the regulation, they are not qualified export assets and DISC status is jeopardized. Even if the regulation of interest-free loans between related entities was a major purpose of Congress in the DISC legislation, the challenged regulations go far beyond addressing that purpose when they add a requirement to the statute which arbitrarily undermines a corporation's DISC status. *See generally,* Comment, *Thomas International, Ltd. v. United States: Regulations in DISCord,* 38 Tax Lawyer 715 (No.3, Spring 1985).

In conclusion, there will be a major conflict between the circuits on the issue of the validity of Treas. Reg. § 1.993-2(d)(2) if the Federal Circuit affirms the Claims Court or if the Seventh Circuit reverses the Tax Court in *Gehl Company v. Commissioner,* P-H Memo T.C. 1984-667 (1984), *appeal*

docketed, No. 85-1326 (7th Cir. Feb. 26, 1985). If the anticipated conflict should develop, Petitioners believe that the Court, in fairness to all interested parties, should not deny certiorari in this case until it has decided to deny certiorari in all the related cases or until the time for filing petitions for certiorari has expired with petitions not filed in the related cases. The resolution of this issue in favor of Petitioners affects all of the taxable years involved in this case.

III. The Eleventh Circuit's Decision Directly Conflicts With Certain Decisions Of This Court Concerning The Scope of Treasury's Authority In Promulgating Interpretive Regulations Under I.R.C. § 7805(a)(1982).

The Eleventh Circuit's conclusion that Treas. Regs. § 1.993-2(d)(2) and § 1.994-1(e)(3) are a reasonable implementation of the Congressional mandate is in conflict with applicable decisions of this Court because the Eleventh Circuit has approved a regulation which attempts to add an exception or fill a loophole Treasury perceives as needed because omitted from the statute by Congress. *See Commissioner v. Acker,* 361 U.S. 87, 92, 80 S. Ct. 144, 147, 4 L. Ed. 2d 127 (1959), where the Court states:

> But the section contains nothing to that effect, and, therefore, to uphold this addition to the tax would be to hold that it may be imposed by regulation, which, of course, the law does not permit. *United States v. Calamaro,* 354 U.S. 351, 359, 77 S. Ct. 1138, 1143, 1 L. Ed. 2d 1394; *Koshland v. Helvering,* 298 U.S. 441, 446-447, 56 S. Ct. 767, 769-770, 80 L. Ed. 1268; *Manhattan General Equipment Co. v. Commissioner,* 297 U.S. 129, 134, 56 S. Ct. 397, 399, 80 L. Ed. 528.

Accord, Helvering v. Credit Alliance Corp., 316 U.S. 108, 113, 62 S. Ct. 989, 992, 86 L. Ed. 1307 (1942) (regulation not only contradicted the statute, but "attempted to add a supplementary legislative provision").

The Claims Court in *Thomas International* held that the sixty-day payment regulation attempted to legislate an exception or improvement to the statue. Another problem with the challenged regulations, though not mentioned by the Claims

Court and ignored by the Eleventh Circuit, is that they directly contradict I.R.C. § 992(a)(1)(B) (1982), which requires that testing of qualified export assets, as defined in I.R.C. § 993(b) (1982), be conducted "at the close of the taxable year." Petitioners are aware of only two exceptions to the statutorily prescribed testing date, and both exceptions are designed to *benefit* the taxpayer by permitting retroactive qualification of the DISC despite the status of DISC assets at the close of the previous year. *See* I.R.C. § 992(c) (1982) (distribution to meet DISC qualifications may be made after the close of the taxable year to preserve DISC status for the taxable year) and I.R.C. § 993(b)(9) (1982) (providing for qualified export asset treatment of bank deposits that are utilized after the close of the year to acquire qualified export assets). No other exceptions to the testing date are contained in the statute, and none were intended by Congress. Yet, Treasury issued the sixty-day payment regulations which ignore the testing date by retroactively disqualifying commissions receivables by testing them sixty days *after* the testing date. The Eleventh Circuit's analysis that the challenged regulations are necessary to prevent circumvention of the producer's loans requirements under I.R.C. § 993(b)(5) and (d) (1982) is irrelevant because even producer's loans are tested *at,* not *after,* the testing date prescribed in I.R.C. § 992(a)(1)(B) (1982). In conclusion, the challenged regulations' contradiction of the statute makes them invalid under cases such as *Helvering v. Credit Alliance Corp.,* 316 U.S. 107, 62 S. Ct. 989, 86 L. Ed. 1307 (1942).

The challenged regulations are arbitrary additions to the statute, according to the Claims Court, with which Petitioners agree. *Thomas International,* 6 Cl. Ct. at 420, 54 AFTR 2d 84-6075 (1984). Therefore, they implement the statute in an unreasonable manner and are invalid under the reasoning of cases such as *United States v. Vogel Fertilizer Co.,* 455 U.S. 16, 102 S. Ct. 821, 70 L. Ed. 2d 792 (1982) and *Rowan Companies, Inc. v. United States,* 452 U.S. 247, 101 S. Ct. 2288, 68 L. Ed. 2d 814 (1981).

IV. The Commissions Receivables Issues And The Producer's Loan Issue Present Important Questions Of Federal Law Not Previously Decided By The Court.

Petitioners are aware of several taxpayers across the country

who have lost DISC status under the Treasury's sixty-day payment rule for commissions payable to a DISC by its related supplier. Though some of these situations have been settled and some are still under audit, the taxpayers with whom Petitioners have communicated have unanimously expressed that they feel the regulations are harsh and unjustified. At least four other taxpayers have litigated the issue and three of the litigated cases have been appealed. Thus, there is significant taxpayer concern about the ultimate resolution of this issue. Although the issue may seem extremely technical and narrow, it is nonetheless important because of its impact on taxpayers' DISC status.

The DISC program has been effectively replaced with a new program called the Foreign Sales Corporation ("FSC"), beginning in 1985. *See* I.R.C. §§ 921-927 (Prentice-Hall Ed. 1985). Though the DISC program has been replaced, the issues in this case are still important for two reasons. First, there are still pre-1985 DISC years open to examination by the Commissioner. Second, the Court's refusal to accept regulatory abuse by Treasury would be an important precedent and might give Treasury further insight as to the proper scope of interpretative regulations, thereby preventing problems with the final regulations on FSCs when they are issued.

The producer's loan issue is important because the Court has not previously addressed Petitioners' argument in the courts below that substantial compliance with statutory requirements is sufficient where the taxing statute involved is quasi-regulatory in nature, that is, not designed to raise revenue, but to achieve an economic or social goal of Congress. Petitioners substantially complied with the requirement of I.R.C. § 993(d)(1)(B) (1982) that a producer's loan be evidenced by a note "with a stated maturity date not more than 5 years from the date of the loan." The purpose of the statute must be examined to illustrate how Petitioners substantially complied. The purpose of the five-year maturity was to insure that loans are tested at least every five years to determine, before new loans are made, that required amounts of increased export activity and export-related expansion of production capacity have occurred. This testing is found in the borrower's limitation prescribed by I.R.C. § 993(d)(2) (1982) and the increased investment requirement under I.R.C. § 992(d)(3) (1982).

Petitioners believe that they substantially complied with the

statute when they renewed demand notes within five years from the date of the original loans, because the renewal loans were retested under the borrowers' limitation and increased investment requirements within five years after the dates of the original loans. The Eleventh Circuit agreed with Petitioners that testing under the borrower's limitation and increased investment requirement is one purpose of the legislation, but stated that "an even more important purpose was assuring that the profits of the DISC were used exclusively for export production and were not syphoned off to benefit domestic production." *CWT Farms,* 755 F.2d at 796, 55 AFTR 2d at 85-1212. This additional purpose discussed by the Eleventh Circuit, however, is the same as the purpose for retesting of loans, because testing of loans under the borrower's limitation and increased investment requirement is the *only* mechanism in the statute to assure that loans are used for export-related purposes. The colloquy between Mr. John Nolan and Senator Nelson in the Senate hearings on the DISC legislation bears this out:

> "MR. NOLAN. The important thing is to limit the extent to which the DISC profits can be used by the parent company, and we have limited the loans to producers to the proportion of the total investment in these kinds of manufacturing assets which the producer's export sales bear to its total sales, and we have required that there be an investment by the borrower in its U.S. assets in the amount of the borrowed funds in the year the loan is made.
>
> We think that this is a reasonable and fair limitation. We further provide that the loans can be made for only a five-year period so that this testing for any loan has to be redone every five years. We think this will insure that the company is maintaining or increasing its level of export sales or increasing its U.S. investment in order to continue to enjoy these benefits.
>
> I can only say that overall we think that we have achieved a reasonable and workable limitation without getting into the difficulty of tracing dollars."
>
> "SEN. NELSON. But it seems to me that you are creating the following situation, the parent company can create a DISC company and then can borrow

from DISC profits on which no taxes are paid, to invest in inventory, machinery, equipment, fixe assets.

It seems to me that this is a device for giving a domestic company a cheap loan. It thus puts itself in a much better competitive situation vis-a-vis any company that does not establish a DISC."

"MR. NOLAN. I understand the argument, but any viable American company is also going to have funds flowing into the company from its current profits on its transactions, from its borrowings, from a variety of sources, and it is impossible to say which dollars are being used for which purposes. We feel that if we limit the total amount of these borrowings which are permissible to that portion of the assets of the company which are really devoted to export activities and if we require that this testing be redone every five years, we have achieved a reasonable limitation on the use of these profits. To the extent a company ties up its productive capacity for export activities out of DISC loans, it is not competing with a company selling solely in the domestic market."

Hearings on H.R. 10947 before the Senate Committee on Finance, 92d Cong., 1st Sess., pt. 1 at 18-19 (1971).

In conclusion, Petitioners ask the Court to grant the petition because the commissions receivables issues are important to numerous taxpayers. In addition, the producer's loan issue presents a novel question of whether substantial compliance with quasi-regulatory statutes is sufficient to entitle a taxpayer to the benefits of the statute.

V. Conclusion

The petition for writ of certiorari to the Eleventh Circuit should be granted. Respectfully submitted,

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APPENDIX

CWT FARMS, INC. and CWT International, Inc.,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 84-8012.

United States Court of Appeals, Eleventh Circuit.

March 19, 1985.

Taxpayers, a parent corporation and its wholly owned subsidiary, each filed petition for redetermination of deficiencies in federal corporate income taxes assessed by the Commissioner of the Internal Revenue Service, based on determination that subsidiary was not a domestic international sales corporation. The United States Tax Court, 79 T.C. 1054, on reconsideration of an earlier decision, 79 T.C. 86, holding that subsidiary did not qualify as a domestic international sales corporation, entered judgment on finding that commissions receivable due subsidiary were not qualified export assets which would qualify subsidiary as a domestic international sales corporation. Taxpayers appealed. The Court of Appeals, Hatchett, Circuit Judge, held that: (1) loans made by subsidiary to parent corporation were not producer's loans either at time of their execution or at renewal, and thus were not qualified export assets; (2) commissions receivable were not qualified export assets when untimely paid; and (3) Commissioner did not abuse his discretion in applying regulations retroactively.

Affirmed.

W. Woodrow Stewart, Steven A. Cornelison, Gainesville, Ga., for petitioners-appellants.

Glenn L. Archer, Jr., Asst. Atty. Gen., Michael L. Paup, David English Carmack, Tax Division, U.S. Dept. of Justice, Washington, D.C., for respondent-appellee.

Appeal from the Decision of the United States Tax Court.

Before HENDERSON and HATCHETT, Circuit Judge and NICHOLS*, Senior Circuit Judge.

HATCHETT, Circuit Judge:

In this case, we affirm the United States Tax Court's, 79 T.C. 86, determination that CWT International, Inc. did not qualify for tax treatment as a domestic international sales corporation.

CWT Farms, Inc. (Farms) and CWT International (International) are Georgia corporations with their principal places of business in Gainesville, Georgia. Twin Oaks Hatchery, Inc. (Twin Oaks), a domestic poultry producer, organized Farms in 1958 as a sales outlet for its excess broiler chickens for export to the Caribbean and Central and South America. International is the wholly-owned subsidiary of Farms. Farms created International as a commission agent for its export sales to take advantage of the tax savings provided for domestic international sales corporations (DISC). The election to treat International as a DISC was filed on September 7, 1972. Twin Oaks also owns Helen Feed Store, Inc. (H n Feed).

During the years in question, 1975, 1976, and 1977, Farms paid International commissions earned by International as a commission agent DISC.[1] From 1974 to 1976, International made three loans to Farms: each loan was evidenced by a *demand* promissory note. Although the notes were not identified as "producer's loans," the books and records of International placed each of these loans under the heading "producer's

* Honorable Philip Nichols, Jr., U.S. Circuit Judge for the Federal Circuit, sitting by designation.

1.

Year	Amount	Date Paid	# of Days After End of Fiscal Year
9/30/75	$157,538.33	12/15/75	76
9/30/76	145,440.77	12/ 8/76	69
9/30/77	116,142.53	12/20/77	81

Both Farms and International kept their books under an accrual method; commissions, therefore, owed by Farms to International became fixed as of the end of the fiscal year, September 30.

loans."[2] Each of the notes was renewed within five years of

2. Title 26 U.S.C.A. § 993 provides in relevant part:

§ 993. Definitions

(a)(3) Definition of controlled group.—For purposes of this part, the term "controlled group" has the meaning assigned to such term by section 1563(a)....

(b) Qualified export assets.—For purposes of this part, the qualified export assets of a corporation are—

(1) export property...;

(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services... or managerial services in furtherance of the production of qualified export receipts...;

(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation....

....

(d) Producer's loans.—

(1) ... An obligation... shall be treated as arising out of a producer's loan if—

(A) the loan, when added to the unpaid balance of all other producer's loans made by the DISC, does not exceed the accumulated DISC income at the beginning of the month in which the loan is made;

(B) the obligation is evidenced by a note... with a stated maturity date not more than 5 years from the date of the loan;

(C) the loan is made to a person engaged in the United States in the manufacturing, production, growing, or extraction of export property...

(D) at the time of such loan it is designated as a producer's loan.

(2) Limitation.—An obligation shall be treated as arising out of a producer's loan only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower outstanding at the time such loan is made, does not exceed an amount determined by multiplying the sum of—

(A) the amount of the borrower's adjusted basis determined at the beginning of the borrower's taxable year in which the loan is made, in plant, machinery, and equipment, and supporting production facilities in the United States;

(B) the amount of the borrower's property held primarily for sale, lease, or rental, to customers in the ordinary course of trade or business, at the beginning of such taxable year; and

(C) the aggregate amount of the borrower's research and experimental expenditures... in the United States during all preceding taxable years beginning after December 31, 1971,

by the percentage which the borrower's receipts, during the 3 taxable years immediately preceding the taxable year... in which the loan is made... is of the gross receipts during such 3 taxable years from the sale, lease, or rental of property held by such

making of the loans, and each renewal note had a fixed, stated maturity date.[3] Further, the renewal notes of December 1, 1979, and September 1, 1981, stated that they were producer's loans.

In determining the maximum statutory amounts that International could lend to Farms as producer's loans, Farms aggregated its export-related assets with those of Helen Feed and

> borrower primarily for sale, lease, or rental to customers in the ordinary course of the trade or business of such borrower.
>
> (3) ... An obligation shall be treated as arising out of a producer's loan in a taxable year only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower made during such taxable year, does not exceed an amount equal to—
>
> (A) the amount by which the sum of the adjusted basis of assets... on the last day of the taxable year in which the loan is made exceeds the sum of the adjusted basis of such assets on the first day of such taxable year; plus
>
> (B) the aggregate amount of the borrower's research and experimental expenditures... in the United States during such taxable year.
>
> ...
>
> (f) Gross receipts.—For purposes of this part, the term "gross receipts" means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources. In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this part as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commission arose.

3. **Execution**

Date of Demand Notes	**12/15/74**	**12/15/75**	**12/15/76**
Amount	**$66,873.22**	**$79,134.16**	**$72,000.00**
Date of Renewal Note	**12/1/79**	**12/1/80**	**9/1/81**
Maturity Date of Renewed Note	**12/1/84**	**12/1/85**	**8/31/86**

Twin Oaks.[4] Included in this aggregation was an expenditure of $90,377.44 incurred by Twin Oaks for research and experimental costs connected with its ISA VEDETTE flocks in 1976. Farms did not file written statements electing to aggregate the export related assets of its controlled group with International's tax returns for the years 1975, 1976, and 1977. In November, 1978, however, Farms gave the election statements to the revenue agent examining Farms's returns.

On May 28, 1980, the Commissioner filed a Notice of Deficiency determining that International was not a qualified DISC for the taxable years 1975, 1976, and 1977, because it failed to satisfy the qualified export assets test of 26 U.S.C.A. § 992(a)(1)(B) (1982).[5] This determination was based on the findings that International's loans to Farms were not producer's loans under 26 U.S.C.A. § 993(d) (1982), and that the commissions receivable that Farms owed International were not qualified export assets because they were not paid in a timely manner pursuant to Treas. Reg. §§ 1.993-2(d)(2) and 1.994-1(e)(3)(i).[6] As a result of these findings, International

4. *See* 26 U.S.C.A. § 993(a)(3) (providing for the aggregation of export related assets of a control group) at n. 2.

5. Title 26 U.S.C.A. § 992 provides in relevant part:
§ 992. Requirements of a domestic international sales corporation
(a) Definition of "DISC" and "former DISC".—
(1) DISC.—For purposes of this title, the term "DISC" means... a corporation which... satisfies the following conditions for the taxable year:
(A) 95 percent or more of the gross receipts... of such corporation consist of qualified export receipts...
(B) the adjusted basis of the qualified export assets... of the corporation at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year,
(C) such corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year, and
(D) the corporation has made an election pursuant to subsection (b) to be treated as a DISC and such election is in effect for the taxable year.

6. Treas. Reg. § 1.993-2(d)(2) provides in relevant part:
If a DISC acts as commission agent for a principal in a transaction... which results in qualified export receipts for the DISC, and if an account receivable... held by the DISC and representing the commission payable to the DISC as a result of the transaction arises... such account

was disqualified as a DISC for the taxable years 1975, 1976, and 1977.[7] Farms and International each filed a petition for redetermination of deficiencies in federal corporate income taxes in the United States Tax Court. On July 19, 1982, the Tax Court ruled against them, finding that the demand notes, even as renewed, were not producer's loans. Consequently, International did not qualify as a DISC because 95 percent of its assets were not qualified export assets. The Tax Court, therefore, found it unnecessary to determine whether any of the other requirements for DISC qualification were met. Farms and International, however, filed a motion for reconsideration asking for a determination of whether the commissions receivable due International were qualified export assets. Under the statutes and regulations, International could qualify as a DISC if Farms made a "deficiency distribution to its shareholders in an amount equal to the fair market value of those assets which are not qualified export assets." 26 U.S.C.A. § 992(c)(1)(1982). The Tax Court granted the motion for reconsideration and held that the commissions receivable were not qualified export assets because they were not paid within sixty days after close of the taxable year as required by Treas. Reg. §§ 1.993-2(d)(2) and 1.994-1(e)(3)(i).

Farms and International appeal. They contend (1) that they complied or substantially complied with the provisions of 26 U.S.C.A. § 993(d)(1)(B) relating to producer's loans, and (2) that Treas. Reg. §§ 1.993-2(d)(2) and 1.994-1(e)(3) are invalid as (a) conditions added to an unambiguous statute, (b) devoid of legislative authority, (c) contradictory of 26 U.S.C.A. § 992(a)(1)(B), (d) invalidly retroactive, and (e) unreasonable.

receivable... shall be treated as a... [qualified export asset]. *If, however, the principal is a related supplier... with respect to the DISC, such account receivable... will not be treated as a... [qualified export asset] unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e)(3)...* [Emphasis added.]
Section 1.994-1(e)(3)(i) provides, in relevant part:
The amount of... a *sales commission* (or reasonable estimate thereof) actually charged by a DISC to a related supplier... *must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.* [Emphasis added.]

7. The deficiencies for the tax year ending September 30, 1975, were determined to be $173.91, for September 30, 1976, $24,624.41, and for September 30, 1977, $28,965.84.

DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC)

Congress enacted DISC legislation in 1971 to provide tax incentives for United States firms to increase their exports.

> This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.

H.R. Rep. No. 533, 92d Cong., 1st Sess. —, *reprinted in* 1971 U.S. Code Cong. & Ad. News 1825, 1872. A corporation which qualifies as a DISC is not taxable on its profits. Further, the shareholders are only taxable currently on a portion of such profits, the other portion being tax deferred until withdrawn from the DISC or until the corporation ceases to qualify as a DISC. The statutory provisions establishing the DISC scheme are set out at 26 U.S.C.A. §§ 991-997 (1982).

PRODUCER'S LOANS

Of the five qualifying factors for a DISC, the factor relating to "qualified export assets" is brought into question in this case. The qualified export assets test requires that 95 percent of the adjusted assets of the corporation (the DISC) must be "qualified export assets" for the taxable year. Qualified export assets may include a variety of assets including inventory facilities, accounts receivable, and producer's loans to the parent corporation. A loan is a producer's loan, and thus an asset, if it satisfies 26 U.S.C.A. § 993(d) and Treas. Reg. § 1.993-4(a)(4).[8]

8. Treas. Reg. § 1.993-4(a)(4) reads in relevant part:

> (4) *Evidence and terms of obligation.* A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan

Farms and International contend that they have complied with both the statutes and the regulations relating to producer's loans. They contend that a "stated maturity date not more than 5 years from the date of the loan," 26 U.S.C.A. § 993(d)(1)(B), in a demand note is either the date of demand or the date the note is executed, if the loan is paid within five years. They argue that such a reading of the stated maturity date language is consistent with the purpose of the five-year maturity date requirement. This purpose, they argue, is to test the loans to determine whether they are qualified producer's loans under the borrower's limitation of 26 U.S.C.A. § 993(d)(2) and under the increased investment limitation of 26 U.S.C.A. § 993(d)(3). They further argue that the demand notes in this case comply with the statutory purpose: by renewing the notes within the five-year period, all three notes were subjected to a retesting under the borrower's limitation and increased investment requirements under the procedures established in Treas. Reg. § 1.993-4(d).[9] Alternatively, Farms and International contend that *substantial compliance* is the necessary threshold for satisfaction of the DISC requirements; they argue that they have substantially complied.

which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan.

9. Treas. Reg. § 1.993-4(d) reads in relevant part:

(d) *Proof of borrower's compliance with paragraphs (b) and (c) of this section.* For purposes of paragraphs (b) and (c) of this section [providing for the borrower's and increased investment limitations], a DISC shall be prepared to establish initially the compliance of the borrower

The Tax Court held (1) that when International accepted the demand notes as evidence of its loan to Farms, the loans did not qualify as producer's loans at the time they were made, (2) the loans could not at renewal be qualified as producer's loans, and (3), therefore, International was not a qualified DISC. As authority, the Tax Court cites the plain meaning of section 993(d)(1)(B) and the legislative history of the DISC statutes.

The plain meaning of 26 U.S.C.A. § 993(d)(1) is clear: A loan evidenced by a note must have a stated maturity date of not more than five years from the date of the execution of the loan, and such loan must be designated as a producer's loan in order to qualify as a producer's loan and as a qualified export asset. Farms and International's argument that they have complied with this provision has no factual basis. While the loans made to Farms and International were identified in the books of International as producer's loans, they neither had a stated maturity date of not more than five years from the date of the loan, nor were they designated as producer's loans on the face of the notes.

Farms and International argue further, however, that they have substantially complied with the requirements for qualification of producer's loans. The substantial compliance, they reason, is achieved through execution of the loans consistent with Congress's purpose in enacting the producer's loans provisions. This purpose, they assert, is to retest the loans every five years to determine whether they satisfy the borrower's limitations and increased investment limitations as to producer's loans.

While we agree that this is one purpose for enactment of the producer's loan requirements, an even more important pur-

with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954... Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district director. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required, the loan shall be deemed not to be a producer's loan.

Farms and International also argue that the renewals were the same as paying the loans.

pose was assuring that the profits of the DISC were used exclusively for export production and were not syphoned off to benefit domestic production. Critics of the DISC proposal were disturbed that DISC funds might be allocated "entirely to domestic production or... entirely to manufacturing activities overseas." Hearings before the Committee on Finance on the Revenue Act of 1971, 92d Cong., 1st Sess. — (Part 2) at 733-34 (1971) (Statement of Stanley S. Surrey). *See* House Hearings Before the Committee on Ways and Means on Tax Proposals Contained in the President's New Economic Program, 92d Cong., 1st Sess. — (Part 2) at 507 (1971) (Statement of Rep. Henry S. Reuss). The original conception of producer's loans allowed "exporting subsidiaries to lend their retained profits to parent corporations without any time limit and few other restrictions." *See also* House Hearings Before the Committee on Ways and Means on Tax Proposals Contained in the President's New Economic Program, 92d Cong., 1st Sess. — (Part 2) at 634 (1971) (Statement of Ralph Nader). Section 993(d)(1), drafted in such detail, accommodates these criticisms in its imposition of particular formalities in the qualification of producer's loans. Section 993(d)(1) communicates the purpose of ensuring that DISC income is used for export production: first, loan transactions between the DISC and the parent must show both in form and in fact that the loan is to be used for export production; second, the loan must be paid back within five years; and third, if not paid back, the loan is disqualified retroactively as a producer's loan or if extended or renewed, the loan must satisfy the formalities of form and substance of producer's loans at that time.[10] We hold, therefore, that the demand notes in question were neither in compliance nor in

10. The House Report accompanying the DISC legislation states that "if a loan... is not collected by the DISC when it matures or is extended at maturity for a period which does not have a fixed time limit, the loan is to cease to qualify as a producer's loan at its original maturity." H.R. Rep. No. 533, 92d Cong., 1st Sess.—, *reprinted in* 1971 U.S. Code Cong. & Ad. News 1883. *See* S.Rep. No. 437, 92d Cong., 1st Sess—, *reprinted in* 1971 U.S. Code Cong. & Ad. News 1918; Treas. Reg. 1.993-4(a)(2)(v):

§ 1.993-4(a)(2)(v) *Refinancing, renewal, and extension.* For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph [on requirements for qualification as a producer's loan] are met.

substantial compliance with 26 U.S.C.A. § 993(d)(1). Accordingly, the Tax Court did not err in finding that the loans in question were not qualified export assets, and that International did not qualify as a DISC for the years 1975, 1976, and 1977.

COMMISSIONS RECEIVABLE

Validity of Regulations

Farms and International filed a motion for reconsideration with the Tax Court asking that the value of the non-qualified assets be determined so it could make a "deficiency distribution" under 26 U.S.C.A. § 992 in order for International to qualify as a DISC for the taxable years in question.[11] As a prerequisite to exercise of the option of making a deficiency distribution, the corporation must show that its failure to meet the qualified export receipts and qualified export assets tests and the failure to make such distribution prior to the date on

11. Title 26 U.S.C.A. § 992 provides in relevant part:

(c) Distributions to meet qualification requirements.—

(1) In general.—Subject to the conditions provided by paragraph (2), a corporation which for a taxable year does not satisfy a condition specified in paragraph (1)(A) (relating to gross receipts) or (1)(B) (relating to assets) of subsection (a) shall nevertheless be deemed to satisfy such conditions for such year if it makes a pro rata distribution of property after the close of the taxable year to its shareholders (designated at the time of such distribution as a distribution to meet qualification requirements) with respect to their stock in an amount which is equal to—

(A) if the condition of subsection (a)(1)(A) is not satisfied, the portion of such corporation's taxable income attributable to its gross receipts which are not qualified export receipts for such year,

(B) if the condition of subsection (a)(1)(B) is not satisfied, the fair market value of those assets which are not qualified export assets on the last day of such taxable year, or

(C) if neither of such conditions is satisfied, the sum of the amounts required by subparagraphs (A) and (B).

(2) Reasonable cause for failure.—The conditions under paragraph (1) shall be deemed satisfied in the case of a distribution made under such paragraph—

(A) if the failure to meet the requirements of subsection (a)(1)(A) or (B), and the failure to make such distribution prior to the date on which made, are due to reasonable cause; and

(B) ... if such corporation makes such distribution after the 15th day of the 9th month after the close of the taxable year, and amount... treated as interest.

which it was actually made was due to reasonable cause. Further, if the deficiency distribution is made more than nine and one-half months after the end of the taxable year with respect to which it is made, the corporation must pay interest. 26 U.S.C.A. § 992(c)(2)(B). While section 992(c) does specify that the distribution must be made after the end of the taxable year, it does not set a time within which the distribution must be made. The Secretary, through promulgation of Treas. Reg. § 1.992-3(c)(3), requires that the distribution be made within ninety days "from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied... the 95 percent assets test... for a taxable year."[12] The key question before the Tax Court on reconsideration was whether the commissions owed and paid to International by Farms were qualified export assets. To answer the question, we must determine whether Treas. Reg. §§ 1.993-2(d)(2) and 1.994-1(e)(3) are valid regulations.[13]

12. Treas. Reg. § 1.992-3(c)(3) provides in relevant part:

> (3) *Time limit for deficiency distribution.* ...the time limit... for making a deficiency distribution is satisfied if the amount of the distribution... is made within 90 days from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied the 95 percent of gross receipts test or the 95 percent assets test or both tests, for a taxable year.

13. Treas. Reg. § 1.993-2(d)(2) provides in relevant part:

> (d) *Trade receivables—*
>
> (2) ... If a DISC acts as commission agent for a principal in a transaction described in § 1.993-1(b)... which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission), such account receivable or evidence of indebtedness shall be treated as a trade receiveable [sic]. If, however, the principal is a related supplier (as defined in § 1.994-1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively)...
>
> Treas. Reg. § 1.994-1(e)(3) provides in relevant part:
>
> (3)(i) The amount of a... sales commission... actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

The Tax Court found the challenged regulations to be valid. It observed, first, that 26 U.S.C.A. § 993(b) does not expressly include commissions receivable in its definition of qualified export assets, yet, the Secretary has provided, through Treas. Reg. § 1.993-2(d)(2), that commissions receivable in certain situations may constitute qualified export assets. Since Farms was a "related supplier" within the meaning of section 1.994-1(a)(3), the sixty-day rule for payment of commissions receivable applied to the commissions owed International. The commissions were not timely paid. Accordingly, the Tax Court determined that the commissions receivable were not qualified export assets.

The definition of qualified export assets is found at 26 U.S.C.A. § 993(b). That section provides that "accounts receivable" may be qualified export assets if they derive from particular transactions of the DISC. These transactions are identified in 26 U.S.C.A. § 993(a)(1) (1982). They include the sale or exchange of export property and of qualified export assets, the lease or rental of export property, provision of services related to any qualified sale, exchange, lease, rental, etc., provision of engineering or architectural services for construction projects located outside the United States, and the provision of managerial services in the furtherance of other qualified export receipts of the DISC. This section does not identify the acts of a commission agent as a "transaction of such corporation." The only mention of commissions within section 993 is found at subsection (f): "In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this part as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose." 26 U.S.C.A. § 993(f) (1982). The only other relevant mention of commissions is found in 26 U.S.C.A. § 994(b).[14] This section specifically authorizes the Secretary of the Treasury to promulgate regulations concerning the price due to be paid by the DISC or

14. Title 26 U.S.C.A. § 994 provides in pertinent part:
§ 994. Inter-company pricing rules.
...
(b) Rules for commissions, rentals, and marginal costing.—The Secretary shall prescribe regulations setting forth—
(1) rules which are consistent with the rules set forth in subsection (2) for the application of this section in the case of commissions, rentals, and other income....

received by the DISC in cases of commissions, rentals, or sales of export property derived from transactions between a DISC and a related person. In light of the mentioning of commissions in section 993(f) and in section 994(b), the Tax Court determined that at best the reference in section 993(b)(3) to accounts receivable deriving from transactions of such corporation did not clearly include or exclude commissions receivable as accounts receivable.

In other words, section 993(b)(3) provides qualified asset treatment for a DISC's accounts receivable arising out of transactions (e.g., sales) 'of such corporation'; a DISC which functions as a commission agent has no sales. In using the term 'accounts receivable' in section 993(b)(3), Congress may have intended to include only those accounts receivable owed to the DISC for sales *it* made, or owed to the principal, but purchased and held by the DISC, for sales made by the principal where the DISC functioned solely as commission agent. Such interpretation is suggested by the House and Senate committee explanations of section 993(b)(3):

The types of assets classified as qualified export assets are —

* * * * * *

(3) accounts receivable * * * of the corporation *(or if the corporation acts as agent, the principal)* held by the corporation which arose in connection with qualified export sale * * * transactions * * * [H. Rept. 92-533 (1971), 1972-1 C.B. 498, 533; S. Rept. 92-437 (1971), 1972-1 C.B. 559, 614 [emphasis added].

In short, the express reference to commissions in section 933(f) and 994(b) reveals that Congress certainly had in mind that commission arrangements might be used in sales involving DISCs, but it is not at all clear that the reference to accounts receivable in section 993(b)(3) was intended to include commissions receivable owed by a production company to a related DISC acting as selling agent....

[As] the extent to which Congress intended commissions receivable owed by the producer to the related DISC to constitute qualified export assets is unclear... the challenged regulation can in no way be said to contradict or limit the 'unambiguous' language of section 993(b)(3).

79 T.C. 1054 at 1063-1064. Since section 993(b)(3) was ambiguous, the Tax Court correctly sought to determine whether the challenged regulation is consistent with the statutes' origin

and purpose. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 102 S.Ct. 821, 70 L.Ed.2d 792 (1982). The Tax Court understood that a major purpose of the DISC legislation was to guarantee that loans from a DISC to a producer are used to encourage exporting. The Tax Court reasoned that if the producer is not required to pay the commissions within a particular period of time, that producer would have an unlimited use of the tax-deferred DISC income.

> In the absence of the challenged regulation, the receivable representing the debt would be a qualified asset. Thus, the DISC could achieve qualified asset treatment of a 'loan' which was not subject to the producer's loan limitation. The DISC could meet the 95-percent assets test even though its tax deferred profits were not applied solely to export activities. Such result contradicts the purpose for which the DISC legislation was enacted....
>
> If 'accounts receivable' include only the obligations of unrelated third parties, there was no reason to be concerned about disguised loans, but if such receivables included obligations of a related producer, there existed the possibility that for their own reasons, they might postpone indefinitely the payment of such a receivable and thereby frustrate the producer loan limitations. In light of the potential for frustration of a clear congressional purpose we cannot hold that the challenged regulation is unreasonable or out of harmony with the origin and purpose of the DISC provisions.

79 T.C. at 1066.

Farms and International argue that section 993(b)(3) is not ambiguous, and therefore, "the regulations [section 1.993-2(d)(2) and section 1.994-1(e)(3)] add a condition to the statutory requirements and are invalid." *Caterpillar Tractor Co. v. United States,* 589 F.2d 1040, 218 Ct.Cl. 517 (1978). Farms and International contend that the only qualification of which receivables are to be considered "accounts receivable" is whether they arise from transactions identified in section 993(a), defining gross receipts. They reason that since section 993(f) also defines gross receipts, and since that section identifies commissions as a gross receipt, then section 993(f) qualified section 993(a). Commissions receivable, therefore, are accounts receivable because they fall under "transactions of such corporation" under section 993(b) as defined by section 993(a) and (f). Because the statute does not place a limit

on the types of accounts receivable which qualify, and the regulations do, the regulations are contrary to the statute and are invalid. Farms and International rely heavily on the recent case of *Thomas International Ltd. v. United States,* 6 Cl.Ct. 414 (1984), to support their argument that the regulations were invalid. *Thomas International,* however, is not wholly applicable to the validity issue because the Claims Court conceded that "it is unnecessary to decide at this time whether section 1.994-1(e)(3) is valid." *Thomas International,* 6 Cl.Ct. at 421. Rather, the court held that "adoption of the portion of that regulation dealing with commissions, to disqualify a corporation as a DISC under the section 992 test, is in itself unauthorized." *Thomas International* at 421. It is on the question of the authority for the regulations that *Thomas International* has relevance and where we must begin our determination as to the ultimate validity of the regulations.

Our review of the question of validity of the regulations must have as a preliminary task the identification of the kind of regulation involved, thus, identifying the source of the regulation's authority.

> [T]he current trend in tax cases appears to be shifting towards more careful scrutiny of IRS regulations. *See U.S. v. Vogel Fertilizer Co.,* 455 U.S. 16, 24-26, 102 S.Ct. 821, 827-28, 70 L.Ed.2d 792 (1982) (invalidating Treasury Regulation that did not 'harmonize' with the 'origin and purpose' of the enabling act); *Rowan Cos. v. U.S.,* 452 U.S. 247, 252-53, 101 S.Ct. 2288, 2292, 68 L.Ed.2d 814 (1981) (invalidating Treasury Regulation that failed to construe the term 'wages' in 'consistent and reasonable manner'); *U.S. v. Cartwright,* 411 U.S. 546, 557, 93 S.Ct. 1713, 1719, 36 L.Ed.2d 528 (1973) (invalidating Treasury Regulation even though it was 'not, on its face, technically inconsistent' with the enabling provision of the Internal Revenue Code).
>
> [I]t is well settled that a court may, when appropriate, substitute its judgment for an agency's when the regulation is 'interpretative' as opposed to 'legislative.' *General Electric Co. v. Gilbert,* 429 U.S. 125, 97 S.Ct. 401, 50 L.Ed.2d 343 (1976); *Batterton v. Francis,* 432 U.S. 416, 97 S.Ct. 2399, 53 L.Ed.2d 448 (1977).... A Treasury Regulation... promulgated pursuant to the Commissioner's general authority to 'prescribe all needful rules and regulations,' 26 U.S.C. § 7805(a)(1976), is clearly 'interpretative' and therefore calls for less deference than a regulation issued

under a specific delegation of authority to define a particular statutory term. *Rowan Cos., supra,* 452 U.S. at 253, 101 S.Ct. at 2292.

Estate of Applebaum v. Commissioner of Internal Revenue, 724 F.2d 375, 381 n. 5 (3d Cir. 1983).

It has been held that regulations issued pursuant to [specific authority] are legislative. *Yellow Freight System v. United States,* 538 F.2d 790, 795-96 (8th Cir. 1976).

[A] legislative regulation... has the same effect as a valid statute. If valid, we are thus compelled to give effect to it. *Batterton v. Francis,* 432 U.S. 416, 425 n. 9, 97 S.Ct. 2399, 2405 n. 9, 53 L.Ed.2d 448 (1977).

Long v. United States, 652 F.2d 675, 678 n. 7 (6th Cir. 1981). *See United States v. Vogel Fertilizer Co.,* 455 U.S. 16, 24, 102 S.Ct. 821, 827, 70 L.Ed.2d 792 (1982); *National Muffler Dealers Association v. United States,* 440 U.S. 472, 99 S.Ct. 1304, 59 L.Ed.2d 519 (1979). Our first question, therefore, is whether the challenged regulations are supported by the specific authority of 26 U.S.C.A. § 994(b)(1) or by the general authority of 26 U.S.C.A. § 7805(a).

The Tax Court avoided the issue by reasoning that even if not supported by the specific authority of section 994(b), the regulations are supported by the general grant of authority in section 7805. 79 T.C. at 1066-1067. Farms and International argue that the only statutory authority for the challenged regulations is section 7805. They contend that section 994's grant of specific authority is limited to the promulgation of regulations "consistent with the rules... in subsection (a) for the application of *this* section [994]." 26 U.S.C.A. § 994(b)(1) (emphasis added). From their view, "had Congress intended this grant to apply to all transactions between related parties... it would have provided for rules for the application of 'this part' not 'this section.' " The Commissioner argues that the specific authority of section 994 applies to the remaining DISC sections because each section has meaning only when read in the context of the whole DISC legislation. The Commissioner understands that this position is consistent with both the House and Senate reports on the DISC legislation.

The bill also provides that the Secretary of the Treasury may prescribe by regulations intercompany pricing rules consistent with those provided by the bill in the case of export transactions where the DISC does not take title to the property, but instead acts as commission agent for the sale, or is

a lessee of the property which it then subleases to its customers.

H.R.Rep. No. 533, 92d Cong., 1st Sess. —, *reprinted in* 1971 U.S. Code Cong. & Ad. News 1888; S. Rep. No. 437, 92d Cong., 1st Sess. —, *reprinted in* 1971 U.S. Code Cong. & Ad. News 2014.

It is far too apparent, as might have been conceded by the Tax Court, that the Secretary of the Treasury promulgated the challenged regulations under his general authority to "prescribe all needful rules and regulations for the enforcement of this title." 26 U.S.C.A. § 7805(a). Section 994(b), by its terms, is a grant of authority to prescribe rules limited to that section. That this is the intent of Congress is made even more clear by the Commissioner's citing of the House and Senate reports which iterate that the bounds of this specific grant of authority is section 994. Accordingly, the challenged regulations are not legislative, but interpretive.

The standard of review of the validity of an interpretive regulation is whether the regulation "harmonizes with the statutes 'origin and purpose.' " *United States v. Vogel Fertilizer Co.*, 455 U.S 16, 26, 102 S.Ct. 821, 828, 70 L.Ed.2d 792 (1982); *National Muffler Dealers Association v. United States,* 440 U.S. 472, 477, 99 S.Ct. 1304, 1307, 59 L.Ed.2d 519 (1979). The challenged regulations, therefore, must be in harmony with the purpose of the overall DISC legislation, sections 991-997, not just that of section 994 as Farms and International have argued. *See U.S. v. Vogel Fertilizer,* 455 U.S. 16, 102 S.Ct. 821, 70 L.Ed.2d 792 (1982); *Long v. United States,* 652 F.2d 675 (6th Cir. 1981).

As identified under the discussion of producer's loans, the purpose of the DISC provisions was to give tax breaks to domestic producers when and for only so long as the income produced under this tax benefit program is used for export production and not for domestic purposes. The Claims Court in *Thomas International* implies, if not suggests, that a principal purpose of the DISC legislation was to provide for commission DISCs and to give them a substantial degree of protection. Taking the view that a commission DISC subject to the challenged regulations would have substantial problems qualifying as a DISC under the qualified export test, the court reasoned:

To avoid disqualification of commission DISCs, 'accounts receivable... which arise by reason of transaction of such

corporation (the DISC)' must necessarily be understood to include sales in which the DISC is assigned by the producer the role of commission agent rather than reseller.

Thomas International at 419. There is no question that Congress contemplated that a DISC may function as a commission agent in certain circumstances. *See* 26 U.S.C.A. §§ 993(f) and 994(b). No where in the statutory scheme, however, does any evidence exist that Congress intended Commission DISCs to assume a preferred position over buy-sell DISCs. Indeed, given the ambiguity inherent in the scant references to commission DISCs in section 993(f) and in section 994(b), it is quite reasonable to conclude that the plight of commission DISCs was, at best, of secondary importance to the drafters of the DISC legislation. Further, the major purpose of the DISC statutory scheme is to assure that the income generated by the DISC goes to export production. As the Commissioner argues, to invalidate the challenged regulations, which do no more than set a due date for the payment of commissions receivable, would run counter to the purpose of regulating the interest-free loans that the DISC is able to make to a related person. Accordingly, we hold that Treas.Reg. 1.993-2(d)(2) and 1.994-1(e)(3) are harmonious with the origin and purpose of the DISC legislation. The challenged regulations, therefore, are valid.

Retroactive Application of Regulations

Farms and International argue that the sixty-day rule is invalid as applied to them retroactively. The scenario on which this claim is based was amply described by the Tax Court:

The DISC provisions (sections 991-997) were contained in the Revenue Act of 1971, Pub.L. 92-178, 85 Stat. 535. A corporation could qualify as a DISC for any taxable year beginning after December 31, 1971. Sec. 507, Rev. Act of 1971, *supra,* 85 Stat. 553. In January 1972, the Treasury published 'DISC—A Handbook for Exporters' (Handbook) containing a 'plain language' explanation of the law pertaining to DISCs. The Handbook provided that accounts receivable which arose in connection with the DISC's qualified export sale transactions were qualified export assets whether the DISC acted as principal or agent. The Handbook did not expressly refer to commissions receivable. *The IRS promised that it would follow the rules*

explained in the Handbook until such rules were modified 'in regulations or other Treasury publications.' The Handbook provided that any such modifications adverse to taxpayers would be applied only prospectively. On September 21, 1972, the Commissioner proposed section 1.994-1(e)(3). Income Tax Regs., 37 Fed. Reg. 19625, 19627-19628, and on October 4, 1972, the Commissioner proposed section 1.993-2(d)(2), Income Tax Regs., 37 Fed. Reg. 20853, 20858. These proposed regulations were the first pronouncements concerning the treatment of commissions receivable, and they both contained the 60-day payment rule. Proposed section 1.994-1(e)(3) was finally adopted on September 29, 1976 (T.D. 7435, 1976-2 C.B. 238) and contained the 60-day rule; proposed section 1.993-2(d)(2) was finally adopted on October 14, 1977 (T.D. 7514, 1977-2 C.B. 266), and incorporated the 60-day rule by reference to section 1.994-1(e)(3). *Section 1.993-2(d)(2), Income Tax Regs., was made applicable to taxable years ending after December 31, 1971.*

79 T.C. at 1067-1068 (emphasis added).

Internal Revenue Regulations are presumed to have retroactive effect. *Anderson, Clayton & Co. v. United States,* 562 F.2d 972 (5th Cir.), *cert. denied,* 436 U.S. 944, 98 S.Ct. 2845, 56 L.Ed.2d 785 (1978). *See* 26 U.S.C.A. § 7805(b) (1967). Under section 7805(b), the Secretary of the Treasury has broad discretion to limit the retroactive application of Treasury rulings and regulations. "The decision to make a ruling or regulation retroactive will stand unless it constitutes an abuse of discretion." *Wendland v. Commissioner of Internal Revenue,* 739 F.2d 580, 581 (11th Cir. 1984) (citing *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180, 184, 77 S.Ct. 707, 710, 1 L.Ed.2d 746 (1957). An abuse of discretion may be found where the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm.

Farms and International argue that an abuse of discretion occurred because the Commissioner made an explicit promise in the Handbook that (1) the Internal Revenue Service would follow the rules and procedures set forth in the Handbook until those rules and procedures are "modified" by "regulations or other Treasury publications"; and (2) that any adverse modifications would be applied only prospectively. They argue that they justifiably relied on the Handbook since the pro-

posed regulations issued in 1972 were not "modifications" of the Handbook, and, even if they were, according to the promise of the Handbook, they should be applied only prospectively. Farms and International rely on the recent case of *Lecroy Research Systems Corp. v. Commissioner,* 751 F.2d 123 (2d Cir. 1984) *(Lecroy).*

The Second Circuit, in *Lecroy* found that the Commissioner committed an abuse of discretion in applying the identical regulations challenged here retroactively because that court found the promise in the Handbook to be binding. The court noted that "retroactive application is permissible even where the regulation contradicts a previous Treasury publication such as the Handbook," but observed that "the Handbook's assurances were deliberately unusual in purporting to offer safety in the *status quo* and were obviously prompted by the need to render the incentives Congress intended to create operable as soon as possible." *Lecroy* at 126, 127. The Second Circuit announced and applied the rule that "absent this assurance of prospectivity to taxpayers... the regulation in question could clearly have been imposed retroactively." *Lecroy* at 126. As authority, the court cites the former Fifth Circuit case of *Carpenter v. United States,* 495 F.2d 175, 184 (5th Cir. 1974). *Carpenter,* in fact, contradicts this proposition. In *Carpenter,* a petroleum engineer who had been working in the Middle East for ten years brought a suit for redetermination of a tax deficiency for that period under a statute permitting a bona fide resident of a foreign country for a particular tax year to exclude from income amounts earned from non-United States sources during that period of absence. The taxpayer argued that he maintained his status as a "foreign resident" during the taxable year in question by following the prescriptions of a Treasury Department publication. The former Fifth Circuit held that the taxpayer's reliance was misplaced.

> We do not fault the Treasury Department for trying to provide guidelines for taxpayers confronted with the bewildering maze of our tax laws, and we sympathize with the taxpayer who in fact relies upon what he accepts as an authoritative interpretation of the laws and of the Treasury publication. But nonetheless it is for the Congress and the courts and not the Treasury to declare the law applicable to a given situation. As the Ninth Circuit has observed: 'Nor can an interpretation by taxpayers of the language used in

government pamphlets act as an estoppel against the government nor change the meaning of taxing statutes...' *Adler v. Commissioner of Internal Revenue,* 9 Cir. 1964, 330 F.2d 91, 93.

Carpenter v. United States, 495 F.2d at 184. It is settled law that Treasury publications such as the Handbook, which purport to provide a general explanation of the revenue laws, are simply guidelines for taxpayers and do not bind the Commissioner in subsequent litigation. *Carpenter v. United States,* 495 F.2d 184. *See also United States v. New York Telephone Co.,* 644 F.2d 953, 959 n. 10 (2d Cir. 1981).

It is unfortunately all too common for government manuals, handbooks, and in-house publications to contain statements that were not meant or are not wholly reliable. If they go counter to governing statutes and regulations of the highest or higher dignity, e.g. regulations published in the Federal Register, they do not bind the government, and persons relying on them do so at their peril. *Caterpillar Tractor Co. v. United States,* 589 F.2d 1040, 1043, 218 Ct.Cl. 517 (1978) *(A Handbook for Exporters,* a Treasury publication). *Dunphy v. United States* [529 F.2d 532, 208 Ct.Cl. 986 (1975)], *supra* (Navy publication entitled *All Hands).* In such cases it is necessary to examine any informal publication to see if it was really written to fasten legal consequences on the government. *Dunphy, supra. See also Donovan v. United States,* 433 F.2d 522 (D.C. Cir.), *cert. denied,* 401 U.S. 944, 91 S.Ct. 955, 28 L.Ed.2d 225 (1971). *(Employees Performance Improvement Handbook,* an FAA publication) (merely advisory and directory publications do not have mandatory consequences).

Bartholomew v. United States, 740 F.2d 526, 532 n. 3 (7th Cir. 1984) (quoting *Fiorentino v. United States,* 607 F.2d 963, 968, 221 Ct.Cl. 545 (1979), *cert. denied,* 444 U.S. 1083, 100 S.Ct. 1039, 62 L.Ed.2d 768 (1980).

Lecroy's proposition that the statements in the handbook were binding is inapposite to the accepted law among the circuits that publications are not binding.[15] We find that the

15. As the Tax Court reasoned, however, even if the promises in the Handbook were found to be binding, the Commissioner did not break the promises. Proposed regulation 1.993-2(d)(2) which contained the original sixty-day rule was a subsequent Treasury publication. "This proposed regulation was published before the beginning of the taxable years at issue; thus, this modification of the Handbook's provisions was in effect during such years." 79 T.C. at 1069.

Commissioner did not abuse his discretion in promulgating the challenged regulations. First, Farms and International did not justifiably rely on the Handbook. Taxpayers who rely on Treasury publications, which are mere guidelines, do so at their peril. *Caterpillar Tractor v. United States,* 589 F.2d 1040, 1043, 218 Ct.Cl. 517 (1978). Further, the Treasury's position on the sixty-day rule was made public through proposed section 1.993-2(d)(2) in 1972, before the taxable years at issue. *Charbonnet v. United States,* 455 F.2d 1195, 1199-1200 (5th Cir. 1972). *See also Wendland v. Commissioner of Internal Revenue,* 739 F.2d 580, 581 (11th Cir. 1984). Second, whatever harm has been suffered by Farms and International resulted from a lack of prudence. As even the *Lecroy* court has recognized, "safety lies in complying with proposed regulations." *Lecroy* at 127. *See also* 79 T.C. at 1069. "Thus, taxpayers knowingly engaged in... questionable transaction(s), the legitimacy of which depended upon... invalidation of proposed regulations. Under such circumstances, the Commissioner cannot be said to have abused his discretion in giving the [regulation] retroactive effect." *Wendland,* 739 F.2d at 582. Finally, the challenged regulations did not "alter settled prior law." Absent the adoption of the challenged regulations, the treatment of commissions receivable was not settled law. In light of the lack of any definitive treatment of commissions receivable, Farms and International had no "vested interest in a hypothetical decision in... [their] favor prior to the advent of the regulations." *Helvering v. Reynolds,* 313 U.S. 428, 433, 61 S.Ct. 971, 974, 85 L.Ed. 1438 (1941); *Chock Full O' Nuts Corp. v. United States,* 453 F.2d 300, 303 (2d Cir. 1971). We find, therefore, that the Commissioner did not abuse his discretion in applying retroactively Treas. Reg. 1.993-2(d)(2) and 1.994-1(e)(3).

CONCLUSION

We conclude that the loans made by International to Farms were not producer's loans either at the time of their execution or at renewal, that the commissions receivable were not qualified export assets when untimely paid, and that the Commissioner did not abuse his discretion in applying retroactively the challenged regulations. We hold, therefore, that International did not qualify as a DISC for the taxable years 1975, 1976, and 1977. The Tax Court ruling is affirmed.

AFFIRMED.

United States Court of Appeals
FOR THE ELEVENTH CIRCUIT

No. 84-8012

T.C. Docket Nos. 16365-80
16367-80

CWT FARMS, INC., and CWT INTERNATIONAL, INC.,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE SERVICE,

Respondent-Appellee.

Appeal from the Decision of the United States Tax Court

Before HENDERSON and HATCHETT, Circuit Judges, and NICHOLS*, District Judge.

J U D G M E N T

This cause came on to be heard on the transcript of the record from the United States Tax Court, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the decision of the Tax Court in this cause be and the same is hereby, AFFIRMED:

It is further ordered that petitioners-appellants pay to respondent-appellee the costs on appeal to be taxed by the Clerk of this Court.

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*Honorable Philip Nichols, Jr., U.S. Circuit Judge for the Federal Circuit, sitting by designation.

Entered: March 19, 1985
For the Court: Spencer D. Mercer, Clerk

By: _____
Deputy Clerk

ISSUED AS MANDATE: APR 11, 1985

I.R.C. § 992(a):

(a) Definition of "DISC" and "Former DISC".—

(1) DISC.—For purposes of this title, the term "DISC" means, with respect to any taxable year, a corporation which is incorporated under the laws of any State and satisfies the following conditions for the taxable year:

(A) 95 percent or more of the gross receipts (as defined in section 993(f) of such corporation consist of qualified export receipts (as defined in section 993(a)),

(B) the adjusted basis of the qualified export assets (as defined in section 993(b) of the corporation at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year,

(C) such corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year,

(D) the corporation has made an election pursuant to subsection (b) to be treated as a DISC and such election is in effect for the taxable year, and

(E) such corporation is not a member of any controlled group of which FSC is a member.

(2) Status as DISC after having filed a return as a DISC.—The Secretary shall prescribe regulations setting forth the conditions under and the extent to which a corporation which has filed a return as a DISC for a taxable year shall be treated as a DISC for such taxable year for all purposes of this title, notwithstanding the fact that the corporation has failed to satisfy the conditions of paragraph (1).

(3) "Former DISC".—For purposes of this title, the term "former DISC" means, with respect to any taxable year, a corporation which is not a DISC for such year but was a DISC in a preceding taxable year and at the beginning of the taxable year has undistributed previously taxed income or accumulated DISC income.

I.R.C. § 993(a):

(a) Qualified Export Receipts.—

(1) General rule.—For purposes of this part, except as provided by regulations under paragraph (2), the qualified export receipts of a corporation are—

(A) gross receipts from the sale, exchange, or other disposition of export property,

(B) gross receipts from the lease or rental of export property, which is used by the lessee of such property outside the United States,

(C) gross receipts for services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation,

(D) gross receipts from the sale, exchange, or other disposition of qualified export assets (other than export property),

(E) dividends (or amounts includible in gross income under section 951) with respect to stock of a related foreign export corporation (as defined in subsection (e)),

(F) interest on any obligation which is a qualified export asset,

(G) gross receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States, and

(H) gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC.

(2) Excluded receipts.—The Secretary may under regulations designate receipts from the sale, exchange, lease, rental, or other disposition of export property, and from services, as not being receipts described in paragraph (1) if he determines that such sale, exchange, lease, rental, or other disposition, or furnishing of services—

(A) is for ultimate use in the United States;

(B) is accomplished by a subsidy granted by the United States or any instrumentality thereof;

(C) is for use by the United States or any instrumentality thereof where the use of such export property or services is required by law or regulation.

For purposes of this part, the term "qualified export

receipts'' does not include receipts from a corporation which is a DISC for its taxable year in which the receipts arise and which is a member of a controlled group (as defined in paragraph (3)) which includes the recipient corporation.

(3) **Definition of controlled group.**—For purposes of this part, the term ''controlled group'' has the meaning assigned to the term ''controlled group of corporations'' by section 1563(a), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears therein, and section 1563(b) shall not apply.

I.R.C. § 993(b):

(b) **Qualified Export Assets.**—For purposes of this part, the qualified export assets of a corporation are—

(1) export property (as defined in subsection (c));

(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services described in subparagraph (G) of subsection (a)(1) or managerial services in furtherance of the production of qualified export receipts described in subparagraphs (A), (B), (C), and (G) of subsection (a)(1);

(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraphs (A), (B), (C), (D), (G), or (H), of subsection (a)(1);

(4) money, bank deposits, and other similar temporary investments, which are reasonably necessary to meet the working capital requirements of such corporation;

(5) obligations arising in connection with a producer's loan (as defined in subsection (d));

(6) stock or securities of a related foreign export corporation (as defined in subsection (e));

(7) obligations issued, guaranteed, or insured, in whole or in part, by the Export-Import Bank of the United States or the Foreign Credit Insurance Association in

those cases where such obligations are acquired from such Bank or Association or from the seller or purchaser of the goods or services with respect to which such obligations arose;

(8) obligations issued by a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such bank; and

(9) amounts (other than reasonable working capital) on deposit in the United States that are utilized during the period provided for in, and otherwise in accordance with, regulations prescribed by the Secretary to acquire other qualified export assets.

I.R.C. § 993(d):

(d) Producer's Loans.—

(1) In general.—An obligation, subject to the rules provided in paragraphs (2) and (3), shall be treated as arising out of a producer's loan if—

(A) the loan, when added to the unpaid balance of all other producer's loans made by the DISC, does not exceed the accumulated DISC income at the beginning of the month in which the loan is made;

(B) the obligation is evidenced by a note (or other evidence of indebtedness) with a stated maturity date not more than 5 years from the date of the loan;

(C) the loan is made to a person engaged in the United States in the manufacturing, production, growing, or extraction of export property determined without regard to subparagraph (C) or (D) of subsection (c)(2), (referred to hereinafter as the "borrower"); and

(D) at the time of such loan it is designated as a producer's loan.

(2) Limitation.—An obligation shall be treated as arising out of a producer's loan only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower outstanding at the time such loan is made, does not exceed an amount determined by multiplying the sum of—

(A) the amount of the borrower's adjusted basis determined at the beginning of the borrower's taxable year in which the loan is made, in plant, machinery, and equipment, and supporting production facilities in the United States;

(B) the amount of the borrower's property held primarily for sale, lease, or rental, to customers in the ordinary course of trade or business, at the beginning of such taxable year; and

(C) the aggregate amount of the borrower's research and experimental expenditures (within the meaning of section 174) in the United States during all preceding taxable years beginning after December 31, 1971.

by the percentage which the borrower's receipts, during the 3 taxable years immediately preceding the taxable year (but not including any taxable year commencing prior to 1972) in which the loan is made, from the sale, lease, or rental outside the United States of property which would be export property (determined without regard to subparagraph (C) or (D) of subsection (c)(2)) if held by a DISC is of the gross receipts during such 3 taxable years from the sale, lease, or rental of property held by such borrower primarily for sale, lease, or rental to customers in the ordinary course of the trade or business of such borrower.

(3) **Increased investment requirements.**—An obligation shall be treated as arising out of a producer's loan in a taxable year only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower made during such taxable year, does not exceed an amount equal to—

(A) the amount by which the sum of the adjusted basis of assets described in paragraph (2)(A) and (B) on the last day of the taxable year in which the loan is made exceeds the sum of the adjusted basis of such assets on the first day of such taxable year; plus

(B) the aggregate amount of the borrower's research and experimental expenditures (within the meaning of section 174) in the United States during such taxable year.

(4) **Special limitation in the case of domestic film maker.—**

(A) In general.—In the case of a borrower who is a

domestic film maker and who incurs an obligation to a DISC for the making of a film, and such DISC is engaged in the trade or business of selling, leasing, or renting films which are export property, the limitation described in paragraph (2) may be determined (to the extent provided under regulations prescribed by the Secretary) on the basis of—

(i) the sum of the amounts described in subparagraphs (A), (B), and (C) thereof plus reasonable estimates of all such amounts to be incurred at any time by the borrower with respect to films which are commenced within the taxable year in which the loan is made, and

(ii) the percentage which, based on the experience of producers of similar films, the annual receipts of such producers from the sale, lease, or rental of such films outside the United States is of the annual gross receipts of such producers from the sale, lease, or rental of such films.

(B) Domestic film maker.—For purposes of this paragraph, a borrower is a domestic film maker with respect to a film if—

(i) such borrower is a United States person within the meaning of section 7701(a)(30), except that with respect to a partnership, all of the partners must be United States persons, and with respect to a corporation, all of its officers and at least a majority of its directors must be United States persons;

(ii) such borrower is engaged in the trade or business of making the film with respect to which the loan is made;

(iii) the studio, if any, used or to be used for the taking of photographs and the recording of sound incorporated into such film is located in the United States;

(iv) the aggregate playing time of portions of such film photographed outside the United States does not or will not exceed 20 percent of the playing time of such film; and

(v) not less than 80 percent of the total amount paid or to be paid for services performed in the

making of such film is paid or to be paid to persons who are United States persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(C) Special rules for application of subparagraph (B)(v).—For purposes of clause (v) of subparagraph (B)—

(i) there shall not be taken into account any amount which is contingent upon receipts or profits of the film and which is fully taxable by the United States (within the meaning of clause (ii)); and

(ii) any amount paid or to be paid to a United States person, to a non-resident alien individual, or to a corporation which furnishes the services of an officer or employee to the borrower with respect to the making of a film, shall be treated as fully taxable by the United States only if the total amount received by such person, individual, officer, or employee for services performed in the making of such film is fully included in gross income for purposes of this chapter.

I.R.C. § 994:

SEC. 994. INTER-COMPANY PRICING RULES.

(a) **In General.**—In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts.

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

(b) **Rules for Commissions, Rentals, and Marginal Costing.**—The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a DISC is seeking to establish or maintain a market for export property.

(c) **Export Promotion Expenses.**—For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the United States, but does not include income taxes. Such expenses shall also include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where law or regulations do not require that such property be shipped aboard such airplanes or ships.

I.R.C. § 995(a):

(a) **General Rule.**—A shareholder of a DISC or former DISC shall be subject to taxation on the earnings and profits of a DISC as provided in this chapter, but subject to the modifications of this subpart.

I.R.C. § 995 (b)(1):

(b) **Deemed Distributions.**—

(1) **Distributions in qualified years.**—A shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock in an amount which is equal to his pro rata share of the sum (or, if smaller, the earnings and profits for the taxable year) of—

(A) the gross interest derived during the taxable year from producer's loans,

(B) the gain recognized by the DISC during the taxable year on the sale or exchange of property, other than

property which in the hands of the DISC is a qualified export asset, previously transferred to it in a transaction in which gain was not recognized in whole or in part, but only to the extent that the transferor's gain on the previous transfer was not recognized.

(C) the gain (other than the gain described in subparagraph (B) recognized by the DISC during the taxable year on the sale or exchange of property (other than property which in the hands of the DISC is stock in trade or other property described in section 1221(1)) previously transferred to it in a transaction in which gain was not recognized in whole or in part, but only to the extent that the transferor's gain on the previous transfer was not recognized and would have been treated as ordinary income if the property had been sold or exchanged rather than transferred to the DISC,

(D) 50 percent of the taxable income of the DISC for the taxable year attributable to military property.

(E) the taxable income of the DISC attributable to qualified export receipts of the DISC for the taxable year which exceed $10,000,000.

(F) the sum of—

(i) one-seventeenth of the excess of the taxable income of the DISC for the taxable year, before reduction for any distribution during the year, over the sum of the amounts deemed distributed for the taxable year under subparagraph (A), (B), (C), (D), and (E),

(ii) an amount equal to the amount determined under clause (i) multiplied by the international boycott factor determined under section 999, and

(iii) any illegal bribe, kickback, or other payment (within the meaning of section 162(c)) paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government, and

(G) the amount of foreign investment attributable to producer's loans (as defined in subsection (d)) of a DISC for the taxable year.

Distributions described in this paragraph shall be deemed to be received on the last day of the taxable year of the DISC in which the income was derived. In the case of a distribution described in subparagraph (G), earnings and profits for the taxable year shall include accumulated earnings and profits.

I.R.C. § 996(a)(1):

(a) Rules for Actual Distributions and Certain Deemed Distributions.—

(1) In general.—Any actual distribution (other than a distribution described in paragraph (2) or to which section 995(c) applies) to a shareholder by a DISC (or former DISC) which is made out of earnings and profits shall be treated as made—

(A) first, out of previously taxed income, to the extent thereof,

(B) second, out of accumulated DISC income, to the extent thereof, and

(C) finally, out of other earnings and profits.

I.R.C. § 7805(a):

(a) Authorization.—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

I.R.C. §7805(b):

(b) Retroactivity of Regulations or Rulings.—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

Treas. Reg. § 1.993-2(d):

(d) Trade receivables—(1) In general. [Reserved]

(2) Trade receivables representing commissions. If a DISC acts as commission agent for a principal in a transaction described in § 1.993-1(b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission, such account receivable or evidence of indebtedness shall be treated as a trade receivable. If, however, the principal is a related supplier (as defined in § 1.994-1(a)(3)) with respect to the DISC,

such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) **Indebtedness arising under § 1.994-1(e).** An indebtedness arising under § 1.994-1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a DISC is not a qualified export asset. An indebtedness arising under § 1.994-1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in § 1.994-1(e) (5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in § 1.994-1(e)(5)(i) and (ii), it is not a qualified export asset.

Treas. Reg. § 1.994-1(e)(3)-(5):

(3) Initial payment of transfer price or commission. (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of § 1.992-1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under § 1.993-2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or ex-

ceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see § 1.993-2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)(a) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(b) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(b) With respect to incomplete transactions to which paragraph (c)(5)(i)(b) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(1) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(2) If the transaction is completed by the date on which the

DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(3) The percentage that (i) an amount equal to (a) the amount actually paid by the DISC to the related supplier in respect of the property minus (b) the related supplier's cost of goods sold with respect to the property, bears to (ii) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (iii) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (iv) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(c) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) Subsequent determination of transfer price or commission. The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 which affects the amounts which entered into the determination of the transfer price or commission.

(5) Procedure for adjustments to transfer price or commission. (i)(a) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under §1.993-2(d)(3) as a trade receivable, and thus as a qualified export asset.

(b) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000, which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000-$8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the ac-

count receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under § 1.993-2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export assets.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)(b) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(6) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If the $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500-$8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under § 1.993-2(d)(3) for the last day of such year.

Example (2). Assume the same facts as in example (1) except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under § 1.993-2(d)(3) for the last day of such year.